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SUMMARY

¶1. (SBU) Promoting rural finance has been a Central Government priority during the past year, as government leaders recognize that the significant financial services gap in rural areas adversely impacts efforts to balance the economy. Rural finance reform was a primary focus of the National Financial Work Conference in January 2007, and policies introduced this year have aimed to promote greater competition by facilitating the entry of new players such as village banks into the rural financial sector. Financial regulators face difficult, and in some cases conflicting, objectives to make financial institutions more commercially oriented while also increasing services to rural areas. As a condition of recapitalizing the Agricultural Bank of China (ABC), for example, financial regulators are pressing ABC to establish a broader presence in the countryside. These initiatives, however, would only give farmers minimally improved access to credit unless the Central Government addresses more fundamental issues that limit the creditworthiness of rural borrowers such as land ownership and agricultural insurance, as well as interest rate caps that limit the ability of lenders to price risk accurately. Moreover, rural-to-urban migration combined with the agricultural sector's falling share in the economy will continue to make lending in cities more attractive to banks than investing in rural financial services. END SUMMARY.

PROMOTING RURAL FINANCE IS A GOVERNMENT PRIORITY
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¶2. (SBU) Few rural financial institutions offer loans or deliver other services to farmers. Rural Credit Cooperatives (RCCs) were established to provide such services but have fallen short. Most farmers in rural China have small plots of one-sixth of an acre or less in size and are unable to expand their landholdings, because all land in rural China is owned collectively (farmers lease the land from the government for up to 30 years). Farmers are thus unable to turn the land they lease into collateral for loans. Small businesses are sometimes able to obtain loans in the countryside, but many of these enterprises are state-owned. Financial institutions ironically tend to drain rural areas of capital: they lend out the savings of rural residents to customers in urban areas where there is more collateral, more information about borrowers' credit risks, higher growth and greater wealth.

¶3. (SBU) Improving financial services in rural areas is an important part of the Central Government's efforts to balance the economy. Government leaders recognize that there is a significant financial services gap in rural areas. Rural financial sector reform was a primary focus of the National Financial Work Conference in January 2007 (Ref A). At the March session of the National People's Congress (NPC), Premier Wen Jiabao reiterated the need for reforming rural finance alongside increasing the financial sector's overall degree of openness (Ref B).

¶4. (SBU) The National Financial Work Conference in January and the March session of the NPC launched a series of rural financial sector reform measures:

--Ordered the Agricultural Bank of China (ABC), in the midst of its own reform, to re-establish a broader presence in rural areas and offer more financial services to farmers. In recent years, the ABC, a state-owned commercial bank, has increased its share of lending in urban areas and has had little to do with farmers. Most of its lending in rural areas has been to state-owned enterprises.

--Allowed the Postal Savings Bank of China (PSBC), which was separated from China Post, to extend small-scale loans to farmers. With postal savings branches all over the country, the move to allow lending by PSBC was seen as a means to diversify and increase the number of institutions offering financial services in the countryside. (Comment: Financial regulators had been reluctant to allow the PSBC to engage in large-scale lending given its limited capacity to assess and manage credit risk. End Comment.)

-- Encouraged financial institutions and non-government organizations to introduce microfinance schemes in rural areas.

--Announced new regulations for establishing village level banks, building on pilot projects initiated by the China Banking Regulatory Commission (CBRC) and People's Bank of China (PBOC). The regulations lowered capitalization requirements and mandated that 20 percent of the capital would be sourced from large commercial banks.

MUCH ADO ABOUT MICROFINANCE

¶5. (SBU) The October 2006 visit by Grameen Bank founder and Nobel Peace Prize Winner Mohammed Yunus and the subsequent CBRC announcement on relaxing barriers to market entry for financial institutions in rural areas kicked off a year of intense government, private sector, and NGO interest in microfinance in China. NGOs, including international NGOs such as the Ford Foundation, Mercy Corps, and HOPE International, have been actively promoting microfinance in China for several years. In addition, Chinese organizations such as the China Fund for Poverty Alleviation (CFPA) and Center for Environment and Poverty Alleviation (CEPA) have implemented successful microfinance projects in recent years (see Refs C, D, and E). Farmer cooperatives also have pooled financial resources to provide small loans to members. Contacts in Shanxi Province have told us those informal efforts have been more successful than PBOC-sponsored pilot projects (Ref F).

¶6. (SBU) The Central Government focused much of its attention in 2007 on promoting village-level banks. The first such bank, Yilong Huimin County Bank, was established in Sichuan Province in February. HSBC announced in August that it would be the first foreign bank to establish a village-level bank, having received approval from the CBRC to set up a rural bank with registered capital of RMB 10 million in Hubei Province. The Shanghai-based Chief Economist of the Bank of Communications said in September that rural banks are a recent trend in response to commercial banks' withdrawal from county-level institutions, and while it would be difficult to earn a profit from village-level banks in the near-term, large banks' efforts to offer financial services in rural areas would demonstrate to regulators their political commitment.

¶7. (SBU) Officials at Citibank and Standard Chartered agreed, stating that establishing a village-level bank would not help commercial banks' bottom lines but would be done to facilitate approval of licenses for urban and coastal branches. They maintained that any rural finance initiatives would need to overcome persistent underlying problems that prevent rural residents from accessing credit.

LAND REFORM NEEDED FOR COMMERCIAL VIABILITY

¶8. (SBU) Because farmers are unable to own their own land, and thus pledge land as collateral, lending to farmers is risky. In some localities, farmers are considered low risk for defaults for micro-loans because of their determination to repay their loans, but these small loans to facilitate the purchase of agricultural inputs are not generally considered to be sufficiently profitable for banks given relatively high fixed costs. In other places, farmers are considered high risk because there is no existing culture of repaying loans. The Deputy Head of the Finance Department in Inner Mongolia Autonomous Region told Econoff that if farmers were able to use their land as collateral, it would be a tremendous benefit for the financial sector in Inner Mongolia's countryside.

¶9. (SBU) The Central Government is reluctant to allow land reform, however, due to fears that if market-based land transactions were permitted, there would be significant risks both for ensuring food security, with the potential for transfer of land from agricultural to non-agricultural uses, and protecting farmers' social welfare, as land serves as a form of social security in the absence of a developed social safety net and widespread availability of a broad array of private insurance products (Ref F). As a result, banks shy away from opportunities in the countryside. The Assistant Mayor of a Third-Tier city in Hubei Province, for example, noted in November 2006 that the financial sector in the countryside remains dormant even while banks are pouring into urban areas in Central China and elsewhere (Ref G).

¶10. (SBU) The only rural finance model that appears to have circumvented the land policy challenge is in the livestock sector where farmers are able to borrow money to purchase more livestock and expand their businesses. If they default on these loans, their property (the animals) can be repossessed. Some companies (such as Meng Niu in Inner Mongolia) have effectively utilized this financial model to help both farmers and the companies (Ref H). The livestock model, however, is only viable so long as the livestock sector is growing rapidly (as it is today).

NO AGRICULTURAL INSURANCE TO COVER LOSSES

¶11. (SBU) There is no agricultural insurance, leaving banks hesitant to lend to farmers who may be wiped out by a natural disaster. Although farmers receive many subsidies from the government, agricultural insurance is not one of them. The government provides relief to farmers after natural disasters, but those bailouts are minimal compensation to meet basic needs only and would not be sufficient to repay outstanding loans. While the private insurance market is growing in China, it is not growing nearly as quickly in rural areas. Where insurance is available in the countryside, it is normally in villages close to major cities.

¶12. (SBU) During Econoff's visits to the countryside, farmers repeatedly have lamented that the lack of agricultural insurance leaves them one bad harvest or natural disaster away from poverty. Hedging against such eventualities is one of the major reasons for the high savings rate in rural areas. (Note: The lack of financing for health care and education remains the primary reason for the high savings rate of farmers. End Note.) There clearly is a need for agricultural insurance, but as the representative for an American company based in Western China said, smart companies are not interested in providing low profitability agricultural insurance unless they have a political reason to do so.

INTEREST RATE CAPS IMPEDE RURAL LENDING

¶13. (SBU) An additional impediment to rural lending is interest rate caps that limit the ability of lenders to price risk accurately. While regulators have eliminated interest rate caps in urban lending, the caps -- though loosened to some degree -- are still in place in the countryside, further giving financial institutions pause as to whether or not the benefits of rural lending outweigh the costs.

OVERCOMING THE LEGACIES OF ABC AND THE RCCS

¶14. (SBU) In the past, state-owned banks, the Agricultural Bank of China (ABC) in particular, and rural credit cooperatives (RCC) provided financial services in rural areas. ABC, however, is not a specified financial institution for rural business as its name would suggest. It is one of four state-owned commercial banks running operations nationwide, and its lending has been increasingly concentrated in urban and coastal areas. Despite the Central Government's push for ABC to return to the countryside, Standard Chartered's Senior Economist told Econoff he does not believe ABC will turn into much of a force for rural finance given its focus on profits and its lack of experience in the rural sector. An ABC Branch Manager in Qingdao told Econoff in 2005 that his bank has virtually no business in the countryside, and a local Agriculture Bureau official in Xinjiang Autonomous Region said in 2006 that the ABC's only rural lending is to agricultural state-owned enterprises (Ref I).

¶15. (SBU) RCCs were developed at the local level, and thousands of RCCs operate in rural areas. These institutions still account for 91 percent of agricultural lending in China. Many RCCs have failed, however, because of poor corporate governance, insufficient capital, and inadequate supervision. RCCs lend little money to farmers and instead focus on providing loans to small- and medium-sized enterprises, many of which are state-owned. These loans are supported by local governments which have connections to the companies, and the RCCs' default rates have climbed as these types of loans have increased in number. The manager of Henan's Provincial RCC admitted in 2006 that government pressure to lend to certain companies has led to bad loans at the expense of lending to farmers.

¶16. (SBU) The few successful examples of RCC lending in China are the result of RCCs partnering with private companies. In the Meng Niu case, for example, Meng Niu serves as a guarantor for RCC loans to herders, who then are able to purchase more livestock and sell more milk back to the company (Ref H). An official at the Zongshen Motorcyle company in Chongqing said that Zongshen sometimes works with RCCs to help provide loans to farmers to purchase motorcycles in rural areas. Motorcycle companies in China cannot offer their own financing and therefore must rely on RCCs or other financial institutions to provide loans in the rural sector, which in the case of motorcycles, is one of the fastest growing markets.

THE RURAL-TO-URBAN MIGRATION PHENOMENON

¶17. (SBU) One important factor inhibiting investment in rural financial services is rural-to-urban migration. With between 150 and 200 million farmers already having left the countryside to move to the cities, many banks wonder if there even will be a market to

service in the future. Rural-to-urban migration will have a huge impact on the future of financial services in rural areas, as financial institutions assess the comparative profitability of lending to a shrinking population of farmers versus collecting transaction fees from migrant remittances.

¶18. (SBU) Banks that are willing to go to rural areas, including ABC and PSBC, have found that remittance services is more lucrative than issuing small loans to farmers. On average, more than half of rural income is derived from remittances from relatives in cities.

Discussions with farmers in the countryside have revealed that since relatives normally only return home once a year during the Chinese Lunar New Year, the majority of these remittances are wire transferred via bank cards from urban areas to villages.

¶19. (SBU) There are varying reports on transaction costs on these transfers, with some farmers in Shaanxi Province complaining to Econoff that fees range from eight to twelve percent on the transfer (Ref J). The World Bank's Chief Economist, however, reports that the PSBC transfer system, with its large branch network, is one of the most efficient in the world charging approximately one percent on transfers from cities to the countryside. Regardless of the transfer cost, banks may find that as a result of China's ongoing depopulation of the countryside, operations in rural areas are most profitable when they focus on remittances rather than the loan portfolio, thereby further hindering the development of comprehensive financial services in rural areas.

COMMENT: LOOKING TOWARDS THE FUTURE

¶20. (SBU) Our focus in analyzing China's rural financial reform should be on what large banks such as ABC and PSBC do. While microfinance is garnering significant attention from the government, media, and public, it is not going to have a meaningful impact on rural development and will serve only as an instrument for poverty alleviation. The Central Government might be increasingly tempted to use the ubiquitous Postal Service branches as outlets for domestic banking and insurance services, thereby prompting national treatment concerns with competing foreign firms. Our expectation on the land issue, however, is that there will be no movement on land reform for the foreseeable future due to political considerations.

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